How to Avoid the Worst Style ETFs

Question: Why are there so many ETFs?

Answer: ETF issuance is profitable, so Wall Street keeps cranking out more products to sell.

The large number of ETFs has little to do with serving your best interests as an investor. More reliable & proprietary fundamental data, proven in The Journal of Financial Economics, drives our research and analysis of ETF holdings and provides investors with a new source of alpha. We leverage this data to identify three red flags you can use to avoid the worst ETFs:

1. Inadequate Liquidity

This issue is the easiest to avoid, and our advice is simple. Avoid all ETFs with less than $100 million in assets. Low levels of liquidity can lead to a discrepancy between the price of the ETF and the underlying value of the securities it holds. Small ETFs also generally have lower trading volume, which translates to higher trading costs via larger bid-ask spreads.

2. High Fees

ETFs should be cheap, but not all of them are. The first step is to benchmark what cheap means.

To ensure you are paying at or below average fees, invest only in ETFs with total annual costs below 0.49% – the average total annual cost of the 916 U.S. equity Style ETFs we cover. The weighted average is lower at 0.13%, which highlights how investors tend to put their money in ETFs with low fees.

Figure 1 shows InfraCap Equity Income Fund (ICAP) is the most expensive style ETF and State Street SPDR Portfolio S&P 500 ETF (SPLG) is the least expensive. WBI Investments provides three of the most expensive ETFs while State Street ETFs are among the cheapest.

Figure 1: 5 Most and Least Expensive Style ETFs

Ticker	Name	Style	Total Annual Cost
Most Expensive			
ICAP	InfraCap Equity Income Fund	All Cap Value	3.36%
WBIF	Absolute WBI BullBear Value 3000 ETF	All Cap Blend	1.70%
IPDP	Listed Funds Dividend Performers ETF	All Cap Value	1.70%
WBIG	Absolute WBI BullBear Yield 3000 ETF	All Cap Blend	1.66%
WBIL	Absolute WBI BullBear Quality 3000 ETF	All Cap Blend	1.62%
Least Expensive			
SPLG	State Street SPDR Portfolio S&P 500 ETF	Large Cap Blend	0.02%
BBUS	JPMorgan BetaBuilders U.S. Equity ETF	Large Cap Blend	0.02%
SPTM	State Street SPDR S&P 1500 Composite Stock Market ETF	Large Cap Blend	0.03%
IVV	iShares Core S&P 500 ETF	Large Cap Blend	0.03%
VOO	Vanguard 500 Index Fund	Large Cap Blend	0.03%

Sources: New Constructs, LLC and company filings

Investors need not pay high fees for quality holdings.[1] VictoryShares Free Cash Flow ETF (VFLO) is one of the best ranked style ETFs overall. VFLO's Neutral Portfolio Management rating and 0.21% total annual cost earns it a Very Attractive rating.[2]

On the other hand, State Street SPDR Portfolio S&P 600 Small Cap ETF (SPSM) holds poor stocks and earns our Unattractive rating, despite having low total annual costs of 0.03%. No matter how cheap an ETF looks, if it holds bad stocks, its performance will be bad. The quality of an ETF's holdings matters more than its management fee.

3. Poor Holdings

Avoiding poor holdings is by far the hardest part of avoiding bad ETFs, but it is also the most important because an ETFs performance is determined more by its holdings than its costs. Figure 2 shows the ETFs within each style with the worst portfolio management ratings, a function of the fund's holdings.

Figure 2: Style ETFs with the Worst Holdings

Ticker	Name	Style	Portfolio Management Rating
SIMS	State Street SPDR S&P Kensho Intelligent Structures ETF	All Cap Blend	Unattractive
IPO	Renaissance IPO ETF	All Cap Growth	Unattractive
SPYD	State Street SPDR Portfolio S&P 500 High Dividend	All Cap Value	Unattractive
FLCA	Franklin FTSE Canada ETF	Large Cap Blend	Unattractive
RVER	Trenchless Fund ETF	Large Cap Growth	Unattractive
NXTV	Simplify Next Intangible Value Index ETF	Large Cap Value	Unattractive
NIXT	EA Series Research Affiliates Deletions ETF	Mid Cap Blend	Unattractive
AWEG	Alger Weatherbie Enduring Growth ETF	Mid Cap Growth	Unattractive
NUMV	Nuveen ESG Mid Cap Value ETF	Mid Cap Value	Unattractive
QQQS	Invesco NASDAQ Future Gen 200 ETF	Small Cap Blend	Unattractive
VTWG	Vanguard Russell 2000 Growth Index Fund	Small Cap Growth	Unattractive
VTWV	Vanguard Russell 2000 Value Index Fund	Small Cap Value	Unattractive

Sources: New Constructs, LLC and company filings

State Street and Vanguard appear more often than any other providers in Figure 2, which means that they offer the most ETFs with the worst holdings.

Invesco NASDAQ Future Gen 200 ETF (QQQS) is the worst rated ETF in Figure 2 based on our predictive overall rating. Renaissance IPO ETF (IPO), Alger Weatherbie Enduring Growth ETF (AWEG), and State Street SPDR S&P Kensho Intelligent Structures ETF (SIMS) also earn a Very Unattractive predictive overall rating, which means not only do they hold poor stocks, they charge high total annual costs.

Our overall ratings on ETFs are on our stock ratings of their holdings and the total annual costs of investing in the ETF.

The Danger Within

Buying an ETF without analyzing its holdings is like buying a stock without analyzing its business model and finances. Put another way, research on ETF holdings is necessary due diligence because an ETF's performance is only as good as its holdings. Don't just take our word for it, see what Barron's says on this matter.

PERFORMANCE OF ETFs HOLDINGs – FEES = PERFORMANCE OF ETF

[1] Three independent studies from respected institutions prove the superiority of our data, models, and ratings. Learn more here.
[2] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

Analyzing each holding within funds is no small task. Our Robo-Analyst technology enables us to perform this diligence with scale and provide the research needed to fulfill the fiduciary duty of care. More of the biggest names in the financial industry (see At BlackRock, Machines Are Rising Over Managers to Pick Stocks) are now embracing technology to leverage machines in the investment research process. Technology may be the only solution to the dual mandate for research: cut costs and fulfill the fiduciary duty of care. Investors, clients, advisors and analysts deserve the latest technology to get the diligence required to make prudent investment decisions.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. The stock market is missing footnotes – and only we have that critical data.
2. Legacy fundamental datasets suffer from significant inaccuracies, omissions, and biases.
3. Our proprietary drives novel alpha. Our measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

In The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

Ernst & Young features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Harvard Business School. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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